TARGET PRACTICE

- The Minister of Finance and incoming RBNZ Governor Adrian Orr today released the updated Policy Targets Agreement (PTA).

- The RBNZ is now required to "contribute[e] to maximum sustainable employment" in addition to its inflation mandate. This adjustment was well foreshadowed. The new PTA is similar in spirit both to its predecessor, and to the mandate in Australia.

- Governance changes announced at the same time will bring the RBNZ in line with accepted best practice. The decision-making committee will have up to three external MPC members (from 2019). This may change the dynamics and processes of the decision-making process – especially since minutes and a non-attributed vote count will be published.

- That aside, the announced changes are largely about bringing the legislation into line with existing flexible inflation targeting practices. Focus on the 2% mid-point of the target band has been maintained. We see few implications for the monetary policy outlook.

KEY POINTS

- In a joint statement, the Minister of Finance and new RBNZ Governor Adrian Orr today released the updated PTA, which guides the RBNZ’s conduct of monetary policy. The RBNZ is now tasked with “achieving and maintaining stability in the general level of prices over the medium term and supporting maximum sustainable employment”. This adjustment was well foreshadowed, and is similar to monetary policy targets in the US and Australia.

- The new PTA is similar in spirit to its predecessor and we don’t think it will alter the conduct of policy much. Modern monetary policy is about smoothing the business cycle within the context of an ultimate medium-term inflation target, and this has not changed. In practice, smoothing the business cycle and ‘contributing to maximum sustainable employment’ amount to the same thing. Focus on the 2% mid-point of the target band has been maintained to ensure that inflation expectations remain well anchored.

- The new PTA acknowledges the impact that monetary policy has on the labour market, and we can expect a greater emphasis on labour market outcomes in the RBNZ’s analysis and reporting. The PTA requires that the RBNZ “explain how current monetary policy decisions contribute to supporting maximum levels of sustainable employment within the economy.” In addition, context is given for the RBNZ’s role within the Government’s agenda to “to improve the wellbeing and living standards of New Zealanders through a sustainable, productive and inclusive economy.”

- Committee decision-making will be legislated as part of the Government’s review of the RBNZ Act. A formal MPC will start operating from 2019, with three external and four internal members. The move to a committee is not new in practice but the inclusion of external members is. The changes are in line with accepted international best practice. The single decision-maker model was an outdated legacy from the early days of inflation targeting where accountability was seen as crucial to build credibility. Credibility is now well established.
• The inclusion of external members on the OCR committee may change the dynamics and processes of decision-making – especially since it is relatively heavily weighted towards external members. The aim is presumably to reduce the risk of ‘group think’ and extreme views. It may prove challenging to find an ongoing supply of suitably qualified but disinterested candidates for the external roles, but the idea is sound. A non-voting Treasury observer will also be part of the committee, providing the information on fiscal policy. This may improve policy co-ordination, while maintaining RBNZ independence – a cornerstone of good monetary policy.

• Increased transparency will be part of the legislation – both minutes and the vote count will be released following an OCR decision. The risk is that this practice may stifle free and frank debate and reduce participants’ willingness to change their minds, and this is why the votes will not be attributed. There are pros and cons around transparency, and no obvious ‘best’ approach, but today’s announcement seems like a reasonable compromise, given the trade-offs.

• Ultimately, today’s announcement is part of the ongoing evolution of flexible inflation targeting and its entrenchment in law (as opposed to just in practice, as it has been). Perhaps pre-empting the changes, the Reserve Bank appears to have been at particular pains to point out in recent Monetary Policy Statements that they are (already) flexible inflation targeters who take into account the undesirability of employment – and the economy more generally – from trend.

• While the changes announced today are an acknowledgement of how monetary policy ‘best practice’ has evolved, the RBNZ’s role remains the same and the policy outlook is unaffected. We do not expect the RBNZ to tighten monetary policy until the second half of 2019, broadly consistent with the Bank’s own views.
This agreement between the Minister of Finance and the Governor of the Reserve Bank of New Zealand (the Bank) is made under section 9 of the Reserve Bank of New Zealand Act 1989 (the Act). The Minister and the Governor agree as follows:

### 1. Price stability
a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices.

b) The Government’s economic objective is to promote a growing, open and competitive economy as the best means of delivering permanently higher incomes and living standards for New Zealanders. Price stability plays an important part in supporting this objective.

### 2. Policy target
a) In pursuing the objective of a stable general level of prices, the Bank shall monitor prices, including asset prices, as measured by a range of price indices. The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.

b) For the purpose of this agreement, the policy target shall be to keep future CPI inflation outcomes between 1 per cent and 3 per cent on average over the medium term, with a focus on keeping future average inflation near the 2 per cent target midpoint.

### 3. Inflation variations around target
a) For a variety of reasons, the actual annual rate of CPI inflation may vary around the medium-term trend of inflation, which is the focus of the policy target. Amongst these reasons, there is a range of events whose impact would normally be temporary. Such events include, for example, shifts in the aggregate price level as a result of exceptional movements in the prices of commodities traded in world markets, changes in indirect taxes, significant government policy changes that directly affect prices, or a natural disaster affecting a major part of the economy.

b) When disturbances of the kind described in clause 3(a) arise, the Bank will respond consistent with meeting its medium-term target.

### 1. Monetary policy objective
a) Under Section 8 of the Act the Reserve Bank is required to conduct monetary policy with the goal of maintaining a stable general level of prices.

b) The conduct of monetary policy will maintain a stable general level of prices, and contribute to supporting maximum sustainable employment within the economy.

### 2. Policy target
a) The price stability target will be defined in terms of the All Groups Consumers Price Index (CPI), as published by Statistics New Zealand.

b) For the purpose of this agreement, the policy target shall be to keep future annual CPI inflation between 1 and 3 percent over the medium-term, with a focus on keeping future inflation near the 2 percent midpoint.

c) The Bank will implement a flexible inflation targeting regime. In particular the Bank shall, in pursuing the policy target:

1. have regard to the efficiency and soundness of the financial system;
2. seek to avoid unnecessary instability in output, employment, interest rates, and the exchange rate; and
3. respond to events whose impact on inflation is expected to be temporary in a manner consistent with meeting the medium-term target.

### 3. Transparency and accountability
a) The Bank shall implement monetary policy in a transparent manner. In addition to the requirements of section 15 of the Act the Bank shall in its Monetary Policy Statement (MPS):

1. explain what measures it has taken into account in respect of meeting the requirements of section 2(c) and explain how these matters have been taken into account in its implementation of monetary policy; and
4. Communication, implementation and accountability  
   a) On occasions when the annual rate of inflation is outside the medium-term target range, or when such occasions are projected, the Bank shall explain in Policy Statements made under section 15 of the Act why such outcomes have occurred, or are projected to occur, and what measures it has taken, or proposes to take, to ensure that inflation outcomes remain consistent with the medium-term target.  
   b) In pursuing its price stability objective, the Bank shall implement monetary policy in a sustainable, consistent and transparent manner, have regard to the efficiency and soundness of the financial system, and seek to avoid unnecessary instability in output, interest rates and the exchange rate.  
   c) The Bank shall be fully accountable for its judgements and actions in implementing monetary policy.

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<td>2. when inflation outcomes, and/or expected inflation outcomes, are outside of the target range explain the reasons for this; and</td>
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<td>3. explain how current monetary policy decisions contribute to supporting maximum levels of sustainable employment within the economy.</td>
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